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The Tax Compliance Burden of Small Businesses – A Profile of 50 Companies

Paper Summary

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I. Paper Summary

In an effort to better understand the tax compliance burden of small business (SB) taxpayers, IBM Business Consulting Services conducted facilitated sessions and case studies with SB taxpayers and the paid professionals who provide services to this population.[1] In October 2003, four facilitated sessions, consisting of 9 to 10 participants each, were conducted in two cities (Boston and Chicago). One session was conducted with employees responsible for tax compliance duties within small businesses; another was conducted with SB owners and principals; and two were conducted with paid professionals who provide services to small businesses. Topics of discussion were recordkeeping, tax planning, preparation and filing of federal income and employment tax forms, making tax payments, and working with a paid professional. By hosting separate sessions with SB taxpayers and paid professionals, we were able to collect information about these topics from the perspectives of all parties involved. From December 2003 through early February 2004, 51 case studies were conducted with SB employees and owners, in the form of in-depth personal interviews. These case studies targeted small businesses from around the country and included various types of businesses, industries and geographies.

Together, the results of our facilitated sessions and case studies have provided a strong foundation and knowledge base that will inform data collection and model development. For example, the information gathered will allow us to write more meaningful questions during the questionnaire development phase, ensuring that we create both valid and reliable measures of SB taxpayer activity and burden. In addition, it gives us insight on how certain characteristics of the business or tax compliance process affect SB taxpayer behavior, since behavioral components are to be built into the SB Burden Model. Further, the data we have collected during this phase will also enhance and augment the data collected during quantitative surveys of SB taxpayers and paid professionals, thus providing a deeper understanding of the complex tasks required of small businesses to comply with the federal income and employment tax systems.

I.1 Income Taxes

Broadly speaking, the federal income tax compliance activities of SB taxpayers are similar, in many respects, to those of Wage and Investment (W&I) and Self Employed (SE) taxpayers. However, our preliminary assessment is that the burden of SB taxpayers appears to be greater than that of SE and W&I taxpayers. Recordkeeping, which includes the maintenance of files and databases containing transactional information, is the most burdensome activity reported by the SB taxpayers we interviewed. The majority of SB taxpayers we spoke with report using software packages to help them maintain their records. Many of the paid professionals we spoke

[1] In accordance with the IRS Business Operating Division classification, we use the term Small Business to refer to businesses that file Form 1065 or Form 1120 series income tax returns (excepting 1120H and 1120POL), and report assets of $10M or less.

with indicate that they perform at least some bookkeeping tasks for their clients. SB taxpayers reported spending anywhere from a two hours a year to 40 hours per month on recordkeeping.

Certain characteristics of the business and the industry it operates in can also contribute to recordkeeping burden. Businesses that have accrual based accounting systems, or those with more assets, tend to engage in more recordkeeping. Recordkeeping demands are also greater in the restaurant and retail industries, due to their higher volume of transactional activity; the construction industry, due to its complex accounting system; and in industries concurrently regulated by multiple entities.

Some respondents found it difficult to differentiate between recordkeeping done for general business purposes and that done for tax compliance purposes. Respondents who did attempt to disentangle the two provided a wide range of responses—some saying that all recordkeeping is completed for tax purposes, and some saying that almost no recordkeeping is completed for tax purposes.

SB taxpayers overwhelmingly use a paid professional to prepare their federal and state income tax returns. Many small businesses also have their paid professionals make tax payments on their behalf. However, there are some small businesses that choose to retain responsibility for these tasks themselves. Filing returns and making tax payments are not considered to be particularly burdensome activities, especially when compared to recordkeeping. This is true even for those businesses that do not hire a paid professional to complete these tasks.

I.2 Employment Taxes

Employment tax compliance is considered by small businesses to be a burdensome aspect of the tax system, particularly because there are a number of complex rules and guidelines that can be difficult for the average SB owner to understand.

Through our discussions, two broad approaches to complying with employment tax obligations emerged: (1) the small business hires a payroll vendor for payroll and employment tax processing, but performs some data entry tasks itself, through the use of a software package; and (2) the small business uses a software package to handle the entire payroll and employment tax process, without the use of an outside vendor. The payroll vendors used most are ADP and Paychex. Three primary reasons were cited for using payroll vendors: cost savings, accuracy of payroll and employment tax information, and record privacy. Dependent on the types of services received from their payroll vendors, respondents reported paying between approximately $60 and $500 per month.

Most taxpayers reported spending 2-5 hours per week on employment tax recordkeeping activities. This time is dependent upon the number of employees in their company, the method in which pay checks are produced, the rate of employee turnover, and how employees are paid (hourly versus salary). Respondents were split on what they considered the most burdensome aspect of recordkeeping: some thought that collecting payroll hours was the most burdensome activity, while others thought that general data entry and reconciling errors was the most time consuming activity.

Employment tax form completion, employment tax form submission, and making employment tax payments are not considered to be particularly burdensome activities, especially by those taxpayers who use a payroll vendor or paid professional to undertake these tasks. Among respondents who choose to prepare the return without the assistance of a paid professional, the most time consuming activity of the three is form completion, and even this activity typically takes only 15 minutes to two hours.

Information reporting, such as generating Forms W-2 and 1099, imposes minimal burden. SB taxpayers who prepare and distribute these forms themselves report spending from one to ten hours annually on this task. Burden is reduced even further for those using a payroll vendor.

I.3 Tax Planning

Small business taxpayers use a number of tax specialists for tax planning, including CPAs and financial planners. Tax planning is undertaken primarily to reduce tax liability. To assist in this effort, paid professionals help their SB clients consider the tax implications of different business structures, accounting methods, investment and financing options, and employee benefits packages. They also advise their clients on issues such as estate planning, long-term forecasting, and how to shift or distribute business income. Finally, they counsel their clients when they decide to sell their business or acquire a new one.

For those who regularly seek tax planning guidance, activities typically begin at the end of the business's fiscal year. Certain characteristics of the business are associated with greater tax planning activity: more profitable businesses and businesses with more experienced or educated owners engage in increased levels of tax planning, as do businesses that have highly involved proactive accountants. Some small businesses spend as little as 5 to 10 hours annually on tax planning, while others devote 5 to 10 hours each week to this activity.

Few respondents see tax planning as a tax compliance activity. It is viewed as an optional activity – fulfilling one's tax obligations is not dependent upon whether or not a company has engaged in tax planning. However, from the qualitative research conducted during the design phase of this project and discussions with the IRS Working Group, IBM learned that along with recordkeeping, tax planning compliance activities are considered to be among the most important and time consuming activities that a SB taxpayer can engage in.

I.4 Paid Professionals

Paid professionals include certified financial planners (CFP), accountants, tax advisors, and others who are paid for tax related services. They provide their clients with a variety of services, including: (1) bookkeeping and payroll services, (2) preparation and submission of individual, business income and employment taxes, (3) tax planning, (4) support during IRS audits, and (5) support for tax settlements. The frequency with which they meet with their clients varies, ranging from weekly to once per year. Those SB taxpayers who do work with paid professionals report spending 4 to 180 hours annually with them in order to fulfil their tax obligations and engage in tax planning.

Paid professionals do not have a universal system for billing clients. Some bill on an hourly basis, others have a fixed fee for each type of service, while still others have a fixed monthly or quarterly fee. A combination of these billing methods may also be used. Certain services are more expensive than others, such as tax planning, those resulting in large tax savings, and those that are particularly time consuming such as bookkeeping and payroll. Respondents reported being charged a wide range of fees by their paid professionals. According to respondents these fees ranged from $500 to $15,000 annually.

Changes in tax laws do not always affect the method in which paid professionals bill their clients. Paid professionals reported that their clients expect them to keep abreast of tax law changes. Keeping current on tax laws, therefore, is considered to be part of their overhead costs and is already built into their fees. As a result, paid professionals do not bill separately for tax-related education.